

Investment managers required to keep your best interests in mind

By MICHAEL FRANCIS

March 27, 2004

For the past 10 years, this column has focused on your responsibilities as a 401(k) investor. You know, the never-ending reminders to diversify, warnings about market timing, pleas to save more and explanations of rebalancing.

This quarter, we're going to shift gears and focus on one of your fundamental rights as a 401(k) investor.

The subject of investor rights has received a lot of press over the past 18 months, as investment advisory firms admitted to abusing their clients' trust in pursuit of the almighty dollar.

Some have paid healthy fines, others have been banned from the industry, while still others have faced criminal charges.

Given all of the headlines, it's fair to wonder how these shenanigans might affect your 401(k) account.

The good news is that your retirement plan assets are probably the most legally safeguarded assets you own. That's because over 30 years ago Congress passed a law to protect the retirement plan assets of American workers from unethical activity.

That legislation is called the Employee Retirement Income Security Act and was signed into law on Labor Day 1974 by President Gerald R. Ford.

Under the law, all decisions your employer makes regarding the handling of retirement plan assets must be made exclusively for the benefit of plan participants.

That means every decision your employer makes regarding your 401(k) assets must benefit you alone - not the employer, its shareholders or some other organization the employer may want to curry favor with.

The "exclusive benefit rule" is important when it comes to evaluating the array of companies offering investment management, trustee and recordkeeping services to 401(k)

plans. That's because just about every major bank, broker, insurer and mutual fund wants to handle your company's 401(k) plan. Not because they're such nice guys, but because there is a lot of profit in the endeavor.

Conflict of interest

The key to understanding the 401(k) services industry is the knowledge that 75% of all typical 401(k) plan service fees - and virtually all of the profit - comes from investment management fees.

With competition high, a popular trend in the 401(k) industry is to allow plan participants access to funds from multiple fund families.

In theory, this approach gives participants access to "the best of the best" in fund choices.

In practice, this approach lowers the asset management fees received by the 401(k) service provider.

To compensate, some providers negotiate revenue-sharing agreements with the fund families whose funds they agree to distribute.

Here's where things can get a little sticky.

While 401(k) service providers try to build a competitive list of funds to offer, their primary objective is profits. Some providers will forgo higher quality investment products for ones that agree to share more revenue with them.

This is why many 401(k) service providers offer funds with higher-than-necessary expenses and lower-than-average performance.

Not enough employers recognize the conflict between their duty to offer funds based solely on what is best for their employees and the 401(k) industry's desire to maximize profits.

Herein lies the need for better disclosure.

Pressure for disclosure

Currently, firms that provide 401(k) services are not required to disclose revenue-sharing arrangements, so most do not.

This makes it difficult to know if a fund is being offered because of superior investment performance or because the fund company bought its way onto the service provider's recommended list with a generous revenue-sharing offer.

In your 401(k) plan, the hard work of screening out service providers with less-than-competitive fund choices is the responsibility of your employer.

The U.S. Department of Labor is charged with policing employers to ensure they are looking out for their employees' best interests.

These are two important safeguards that protect your 401(k) investments.

Investors have the right to be protected from arrangements that line the pockets of service providers at the expense of investors' retirement security.

Competition has a way of weeding out the most greedy service providers, so even with little regulatory intervention, the industry is heading in the right direction.

With pressure from employers and plan participants for greater disclosure of fees earned through revenue-sharing agreements, your rights as an investor should continue to improve.

Michael J. Francis is the president and chief executive officer of Francis Investment Counsel LLC, a registered investment adviser based in Hartland. Mike Francis can be reached at michael.francis@francisinvco.com. The information contained herein is provided for informational purposes only. The preceding information has been obtained from sources Francis Investment Counsel believes to be reliable, but Francis Investment Counsel cannot guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes investment advice or a solicitation for the purchase or sale of any security. Past performance does not guarantee future results. Francis Investment Counsel does not offer personal tax or legal advice.